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TRENDS IN FDI INFLOWS AND CURRENT ACCOUNT OF INDIA'S BOP SINCE1991

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ABSTRACT

This paper goes into studying the trends in Foreign Direct Investment and current account of India's BOP since 1991. The formulation of new industrial policy in 1991 provided a strong whip to foreign direct investment in India. Because of liberalisation and relaxations adopted by India in the new policy frame work, there seemed an increase in Foreign Direct Investment in the country. Foreign Direct Investment flows rose from US$97 million in the period 1990-91 to US$ 2,144 million in the period 1995-96;further it went on increasing to US$ 3,557 in the period 1997-98 and to US$ 37,838 in the period 2008-09.The current account of India's BOP follows the same path of flare. Since 1991, India has seen a rise in current account deficit except for a few periods of sustainability. It was in 1989-90 that a CAD of 2.3% of GDP was reached which was quite a comfortable position but that too was wiped off because of the Kuwait's invasion by Iraq in august 1990 resulting in the widening of CAD to 3% of GDP.

KEYWORDS: Foreign Direct Investment, Current Account, CAD, Balance of Payments

INTRODUCTION

Foreign Direct Investment, in general parlance, is the power of an individual or organisation of one country (home country) to invest into the organisation or firms of another country(host country), fulfilling the objective of acquiring a lasting interest in the management of the firm of the host country. For any economy, Foreign Direct Investment is a significant source of gaining improved technical know-how, employment creation opportunities, an improvement in developing the skills and productive capacity of both labours and management of the organisation. But, a developing country like India, after freeing itself from the clutches of British Empire was quite reluctant to open its door for FDI until the middle of 1980s, when the country opened its economy by inviting investments from foreign nations and also by relaxing its trade policy. Before this period, India followed a strict policy of industrialisation with restricting any transfer between residents and non-residents unless specifically permitted. A spur in Foreign Direct Investment since 1991 was initiated by the formulation of new industrial policy which paved the way for allowing foreign equity share upto 51% in high priority areas with also advantages of no restriction on location, technology, repatriation of capital and dividends. Since then, there came new packages of trade policy reforms with each plan document and the improvement in liberalisation went on increasing. This was encouraged as a need to increase international competitiveness of Indian firms and organisations.

The need of rapid industrialisation of Indian economy was at a larger extent made possible by alluring capital and latest technical know-how from foreign investors. The growth of foreign direct investment was found to be phenomenal in the years after the new industrial policy. The movement of foreign investment was found to be more in developing countries rather than in developed countries. This eventual widening of demand for Foreign Direct Investment calls also for an analysis into its spill over effects. The extent to which foreign investment should be invited depends on the domestic

industries also. The share of foreign investor's participation needs to be revised as according to the need. What is of paramount importance, apart from attracting more FDI, is having a check on the impact it has on the balance of payments position. The current account and capital account, both as a significant constituent of the balance of payments, gets affected by foreign investments. India, till middle of 1990s followed a strict policy when it comes to current account. It was after this period that convertibility on current account was enabled. The position was not at all distinct for capital account too; relaxations also followed the same path.

Till the 1990s the current account deficit remained moderate. But, the situation changed since then with an increase in current account deficit from2.3% of GDP in 1989-90 to 3.0% in 1990-91.The figures aren't picturing a smooth momentum but an up-down pattern. Figures reveal that from a comfortable position of 2.3% of GDP, Current account deficit rose to 3% of GDP in the period 1990-91 but , soon after in the period 1991-92 it contracted to 0.30 % of GDP and then yet again it widened and since 2007-08 it is widening with the figures reaching an upsetting position. Foreign direct investment, as a component of capital account of balance of payment is seen as the most stable and effective means needed to finance the current account deficit. The widening of current account deficit alarms the government to raise the foreign direct investment in such numbers as to correct the balance of payments position. As for the foreign investment inflows, whatever increase it showed post 1991 was to a small extent offset by the lowering levels of Foreign Direct Investment inflows in the period of 2010-11 which was very short of the potential level.

Conceptual Framework

Foreign Direct Investment

Foreign Direct Investment as defined by OECD (Organisation for economic co-operation and development) and IMF (International monetary fund) , is an investment involving a long term relationship and reflecting a lasting interest and control by a resident in one economy in an enterprise resident in an economy other than that of the foreign direct investor. To qualify as an FDI, the investment must be made by one investor or by a related group of investors (IMF, 2003). World Bank in 1996 gave a slight different definition yet with similar notion. According to World bank, "FDI is an investment that is made to acquire a lasting management interest (usually 10% of voting stock) in an enterprise and operating in a country other than that of the investors."

Foreign Direct Investment is a topic of paramount importance in the prevalent situation of international competition. Especially, for developing countries, FDI seems to serve as a beacon of economic development and prosperity and this is why the developing countries are tapping hard to lure the foreign investors by offering them an ocean of relaxations; tax concessions, tax holidays, repatriation facilities to name a few. FDI, in simple language, is the mutual interests of multinational/transnational firms and host countries. The real sense in which Foreign Direct Investment is of utmost consideration is that of the blessings it transfers to the host countries in the form of capital, managerial expertise, innovative skills and technical knowledge.

Types of FDI

There predate three major categories of Foreign Direct Investment, the factors underlying their very existence being the motives determining their occurrence. The categorisation is as follows:

Resource Seeking FDI: A type, motivated by the availability of natural resources (mineral, raw materials, agricultural products etc.) in the investing countries. This type of Foreign Direct Investment also seeks low cost labour in

the host countries. In a brief sense, resource seeking FDI aims to exploit the host countries comparative advantage. Still, this type holds good for a quantifiable number of developing countries, yet it has loosed its relevance in the global order.

Market Seeking FDI: A Foreign Direct Investment's category, encouraged by availability of large sized markets in the investing countries and the basic motive behind these are penetrating into the local markets of the host countries. This kind of investment go into manufacturing of a wide variety of household consumer products or industrial goods that may move on to cater their future demand. However, a must condition for this type is the follow up of liberal trade regime by the host country.

Efficiency Seeking FDI: A type motivated by opening up new opportunities for improving efficiency of firms including the improvement in the already existing sources. This category of FDI is seen as the most important type, the reason being, connection of markets and resources on a world wide scale enabling the accentuation in efficiencies of firms and manufacturers.

Theories of FDI

A number of theories were formulated as by different economists on the phenomenon of Foreign Direct Investment, yet the theories that hold well, even in the present era are not in a good number. The theoretical framework of Foreign Direct Investment started with the Theory of Absolute advantage as propounded by Adam Smith and then after the Theory of comparative advantage propounded by David Ricardo in but it proved to be a failure as it did not allow the occurrence of FDI. Other theories evolved in continuation with the Ricardo's theory of comparative advantage; the Portfolio theory and Mundells theory .However, these theories failed on the basis of not providing a proper insight into the direct investment rather these were seen concentrating more on Portfolio investments.

As a great deal of economists have emerged internationally, so is the case with the variability in the generalisations regarding Foreign Direct investment. There seems no single theory on which one can reckon upon to satisfactorily reach a saturation point of determining Foreign Direct Investment. Various theories can be taken into consideration in order to understand the determinants going into attracting Foreign Capital, to name some; the Eclectic paradigm, the Internalisation theory, Theory of Exchange rates, Production cycle theory, Japanese theory etc. However, the Eclectic Paradigm of International Production put forward by J. Dunning is still seen as an appropriate theory for successfully analysing the determinants of foreign activities of international production.

Dunning's Eclectic Paradigm of international production evolved as a phrenic answer to the expanding relevance of international production and of the Multinational/ transnational corporation in the world economy. Though the eclectic theory was put forward in 1976 by Dunning in a Nobel symposium in Stockholm, its sources can be perceived from the middle of 1950s. Dunning, in his research, in 1958 rested on the hypothesis that the increase in labour productivity in US manufacturing industry, as compared with the industry of UK can occur only as a result of either of the two situations; the first being the ownership specific effect and the second being the location specific effect. He further extended this hypothesis to include the third set of choices available to firms referred to as Internalisation advantages. Hence, the eclectic theory is a composition of three advantages underlying the Foreign Direct Investment activities:

''O'' an abbreviation for Ownership advantages

''L'' an abbreviation for Location advantages

‘’I’’ an abbreviation for Internalisation advantages

The central thesis of the eclectic theory, or the eclectic paradigm since the mid-1980s, has always been that channels of international economic involvement or international economic transactions or the international competitiveness of a country’s output of goods and services is determined by the possession of ownership specific endowments of its enterprises, by the ability and desire of these enterprises to internalise these advantages or the markets to these advantages, and by comparative location endowments of home vis-à-vis foreign countries which are exogenous to firms (Dunning,1977).

The ownership specific endowments include all resources whether tangible or Ricardian type factors of production (such as natural resources, labour force, capital) and intangible assets such as knowledge, organisational and entrepreneurial skills and access to intermediate and final goods market taking into consideration the political, cultural, and institutional rules and policies in which the resources are used. These ownership specific endowments may be specific to the home or host country, the industry, or to enterprises (Dunning, 1981b, 1988a).

The location specific advantages include advantages pertaining politically, socially, and economically. The companies owning the factor endowments or having ownership advantages can either use it themselves or can sell them or even provide them on rent. It is solely in their hands how to make utmost use of the available endowments. The companies’ benefit lies in using the endowments themselves rather than providing for sale or rent. The location specific advantages describes a great deal about the countries that may emerge as host countries on the very basis of economic, political or social advantages (an easy and common policy framework affecting FDI, Transportation costs, Tele-communications, Cultural attitudes and beliefs, Labour costs, Market size etc.) they offer to the multinational corporations.

Internalisation advantages relate to the technique the companies undertake to make use of the endowments under their possession and those they are capable to have access to in differing locations. Dunning explained the internalisation advantages in the context that, the explanation of the foreign value-added activities of companies, what holds importance is describing the reasons governing such firms to exploit their ownership specific advantages internally, rather than to acquire or sell these advantages through the open market.

This theory also is known as OLI theory of Foreign Direct Investment.

The Theory of Internalisation: As developed by Buckley and Casson in 1976 and further by Hennart in 1982 and Cass on in 1983 dealt in explaining the enormous growth of transnational corporations and the motives forrealising Foreign Direct Investment. Hymer was the personality behind the emergence of this theory in an international context, in 1976.Dunning also used the internalisation theory in the formulation of his Eclectic theory. Nobody, but the local firms are aware of the true environment of local industries. Thus, for the multinational firms, there existed market imperfections. It was in this regard that Buckley and Casson suggested a way out to this situation of market imperfections by internalising their own markets rather than relying on sale or providing on rent the indigenous technology.

The Theory of Exchange Rates: On imperfect capital markets made an analysis of the impact of variations in exchange rate on the Foreign Direct Investment flows. This analysis, undertaken by Itagaki in 1981 and Cushman in 1985, showed that an upsurge in real exchange rate went into increasing the FDI made by USD whereas an appreciation in foreign currency led to a decrease in American FDI. Although, this theory was a genuine attempt of analysing empirically

foreign exchange risk from the view of international trade, still this theory was limiting in the context of not providing strong explanations regarding contemporaneous FDI among countries with differing currencies.

The Production Cycle Theory: Explained the variety of investments made by the US companies in areas of Western Europe in the period 1950-1970. This theory was developed by Vernon in the year 1966 and mainly discussed about the different kinds of FDI going into the manufacturing industry of Western Europe by the US companies. Vernon in his theory talked on this area of FDI on the basis of division of production cycle into four stages of innovation, growth, maturity and decline. As is the case with US companies, they, in the first place started producing goods using innovative techniques for the local masses for consumption and then exported a part so as to serve the international market. This way the technology the US transnationals adopted gained appreciation and made the European companies imitate their way of production so as to produce goods on their own. Thus, the four stages were discussed by Vernon in the case taken that of US Trans-nationals.

Another theory that marked its existence in the theoretical framework of International trade and Foreign Direct Investment is that given by **Kojima and Ozawa**(Japanese Researchers) in 1984.Both of them just made some alterations and improvements in the model developed by Mundell and based on this model, they reached the end that the reason for the emergence of FDI in a country is the prevalence of comparative dis-advantage in producing a particular product, and the reason for the existence of international trade being the presence of comparative advantage in production of products.

Current account of India's BOP

Current Account Balance

The Current Account Balance is the equalisation made, thereof, of the exports and imports as occurring in the economy. If there shows exports overpowering the imports, we call it as a Surplus Balance of Current Account. However, if there seems an increase in imports much The Current account, one of the two components of Balance of Payments, the other being Capital account, comprises of merchandise exports and imports and invisible exports and imports. Merchandise exports and imports represent credit entries as these transactions give rise to claims on foreigners in monetary term. Merchandise imports are shown in the current account as debit entries as these transaction's leads to a rise in foreign money claims on the home country. Similarly, the invisible export (services) are credit entries and invisible imports are shown as a debit entry.

Current account proves to be an important tool for describing an economy's condition and health. In dealing with transactions related with exports and imports (both visible and invisible) ,the Current Account determines the position of an economy in terms of balance of trade, net current transfers and also net factor income from abroad. Thus, learning the trends of Current Account gives an insight into the macro-economic performance of an economy.

Above the level of exports, then we call it a Deficit Balance in the Current Account. A Current Account Deficit up to a certain limit is digestible for an economy, but Current Account showing high Deficits isn't seen as a good sign for the economy's prosperity and growth. Thus, because of the susceptibility of the topic, study of Current Account Deficit seems a lot important for the benefit of the economy. Moreover, if there happens to be a Surplus in the Current Account, then it is a good sign for the economic condition a country. The Reserve Bank of India is accountable for the Current Account maintenance and execution.

LITERATURE REVIEW

Since the very inception of the idea of liberalising India towards becoming global player in drawing Foreign Investments, researches are being conducted in such numbers that it has become inevitable to drop this topic of great relevance. As it is evident from the present world conditions relating to International Markets that Foreign Direct Investments is providing a good chance of favourability to the developing nations in emerging as a successful economy with a better probability of quenching its thirst of procuring technologies and skills (both managerial and technical). A multitude of studies owing to this acreage of Foreign Direct Investment has eventually also explained the macro-economic variables that are affected in this process of Foreign capital movements, for instance, the Current Account, Capital Account, to name a few.

A quantifiable amount of literature exist delineating the increase in FDI inflows to India soon after the opening of Indian economy in 1991. Baral (2013) in his research work titled " A Study on FDI trends in India " talks about the accrual in Foreign Direct Investment inflows as a consequence of the unlocking of the Indian economy and also as a outcome of unfastening of Capital account. Unveiling the reasons behind the increment in FDI inflows, Baral also took into notice the nature of large FDI flows going into financing the Current Account Deficit pertaining to that very period. The relationship between FDI flows and Current Account were likewise investigated by Siddiqui and Ahmad (2012) empirically using the Johansen-Juselius co-integration technique and the Granger Causality Test. They, in their study perceived that widening current account deficits is one of the least appetizing macro-economic consequences of Foreign Direct Investments. However, large current account deficitis a common phenomenon in context of Developing countries as it is in many of these countries that the swelling wave of FDI flows has corresponded exactly with the broad spectrum of current account deficits. Moreover, this study testimonies only long run uni-directional causality from Foreign Direct Investment to Current Account and there portrayed no short run causality from Foreign Direct Investment to Current Account. The same crux of Foreign Direct Investment causing Current Account imbalance was put forward by Mencinger in 2008. What he attempted is no different from the previous studies as he too enunciated the relation between FDI and Current Account in a demeanour that describes FDI as a no win-win situation. He discussed that the larger the quantum of FDI inflows, the higher will be the Current Account Deficit; the reasons being raised imports and the tendency of FDI driving out the domestic competitors out. Somewhat same findings were that of Kumar (2007), as his assertion was far in FDI's favour. He reached to the conclusion that FDI inflows are risky for the developing nations because of it being a foreign capital, its riskiness is aggravated in the times of financial crisis. The profit repatriation tendencies also exerted a pressure on the current account and led to a deplored current account balance. Woodward in 2003 also rested on the same conclusion of FDI flows causing a great deal of spur in current account deficits. He took into his consideration data of six economies on which basis he was able to present a picturesque of Foreign Direct Investment as one of the leading variable affecting the Current account deficit in the taken economies. Taking Foreign Direct Investment in similitude with loan, the study quibbled of treating the repatriation of capital to the foreign country in same sense as that of repayments of loan.

Thus, a large number of studies stands firm on treating Foreign Direct Investment as a pioneer in affecting the Current Account Balance of an economy, whether empirically or theoretically. Lehman (2002) also based his investigation taking the data of two economies viz. Argentina and Brazil for the time period 1996-2000 and observed that Foreign Direct Investment emerged as the sole catalyst in the widening Current Account Deficits on account of paving way for an increase in repatriation of profits and income.

Trends in Foreign Direct Investment Inflows in India

The Indian Government's initiative in unleashing the economy from restrictive trade policies proved a strong agent in ameliorating Foreign Investment inflows in the country with added benefits of up gradation of technology and skills (both managerial and technical), productivity improvements, increasing export competitiveness etc. provided by the investing country. The FDI Inflows in the country since 1991 up till now is shown in Table 1.

Table 1: FDI Inflows in to India from 1991-92 to 2014-15

Year	FDI Inflows in US$ Million
1991-92	147
1992-93	345
1993-94	651
1994-95	1,351
1995-96	2,174
1996-97	2,864
1997-98	3,596
1998-99	2,518
1999-00	2,170
2000-01	17,720
2001-02	15,488
2002-03	14,001
2003-04	32,682
2004-05	46,934
2005-06	77,298
2006-07	1,33,210
2007-08	2,71,121
2008-09	1,71,660
2009-10	1,98,653
2010-11	2,92,561
2011-12	2,34,618
2012-13	2,15,027
2013-14	2,46,766
2014-15	75,561

Source: RBI, *Handbook of Statistics on Indian Economy*.

Notes:

- Data for 2009-10 and 2010-11 are provisional.
- Data were revised since 2000-01 with expanded coverage to approach international best practices.

Chart- 1

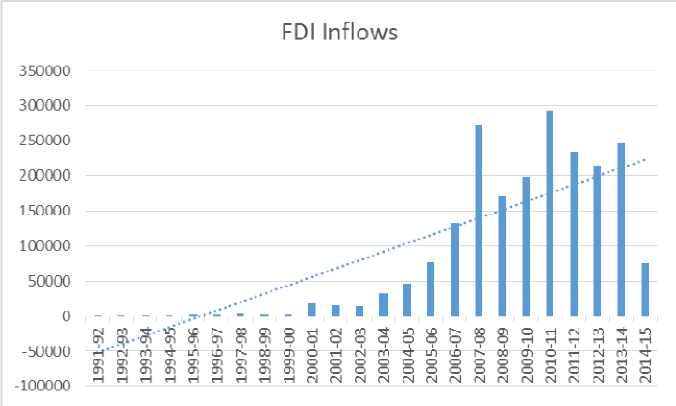

Figure 1

Source: Prepared by Author

The trend in FDI Inflows shows a continuous increase since 1991. The figures in the graph shows an increase in FDI Inflows into India from 107 US$ Million in the period 1991-92 to an overwhelming figure of 2864 US$ Million in 1996-97 and further went on improving reaching a figure of 17,720 US$ Million in the period 2000-01. The credit to this wave of improvement in FDI Inflows post 1991 could be vested on the liberalised policy the Government adopted, with some up gradations like a wider access to more new sectors, profit repatriations, relaxations offered in equity owning etc. Moreover, the largest FDI Inflows was recorded in the period 2010-11 with a figure 2, 92,561 US$ Million. However, it was after this period that FDI Inflows show a slight decline in the consecutive years till 2012-13. The situation improved with slight proportions in the period 2013-14 but again in 2014-15 the FDI Inflows declined much to 75,561 US$ Million. Though, there appeared a decline in FDI inflows in some selective years, but on the whole the FDI Inflows have shown a good growth in terms of a CAGR of 27.91% for the duration of last two decades.

Table 2: Current Account Balance of India’s Bop from 1991-92 to 2014-15

Year	Current Account Balance
1991-92	-1178
1992-93	-3526
1993-94	-1159
1994-95	-3369
1995-96	-5912
1996-97	-4619
1997-98	-5499
1998-99	-4038
1999-00	-4698
2000-01	-2666
2001-02	3400
2002-03	6345
2003-04	14083
2004-05	-2470
2005-06	-9902
2006-07	-9565
2007-08	-15738
2008-09	-27914
2009-10	-38181
2010-11	-48053

2011-12	-78155
2012-13	-88163
2013-14	-32397
2014-15	-10081

Source: RBI, *Handbook of Statistics on Indian Economy*

Chart - 2

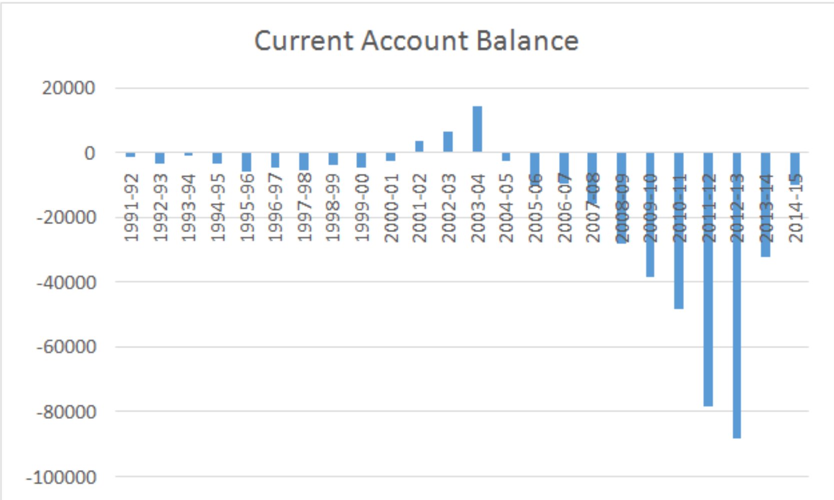

Figure 2

Source: Prepared by Author

The trend in Current Account shows a deficit 1991 onwards and it went on widening except during some periods as in 2001-02 it reached a surplus of 3400 US$ Million and in three consecutive years including 2002-03 and 2003-04, the Current Account valued a surplus of 6345 US$ Million and 14,083 US$ Million. But, this surplus in Current Account, in the very succeeding year lost its consistence and again rolled back to a deficit of 2470 US$ Million in 2004-05. Till then the figures have only shown a plethora of CAD, with a limited sign of surplus in the following years to come. The largest deficit was found during the periods 2011-12 and 2012-13 with the widened figures of 78,155 US$ Million and 88,163 US$ Million respectively. However, the aggravated hike in Current Account Deficits during the period 2011-12 and 2012-13 have got their causal factors in the Balance of Trade in this very period also showing a deficit arising from merchandise goods and gold trade deficits. The Trade deficit factor in the same period has gone into widening the Current Account Deficit as the trade deficit accounted to 10.2% and 10.8% of GDP for 2011-12 and 2012-13. Yet other factors like increase in Gold imports, oil and coal import and a reduction in Iron ore export earnings created a mess in the condition of CAD.

Trends in Foreign Direct Investment Inflows and Current Account of India's BOP

Chart- 3

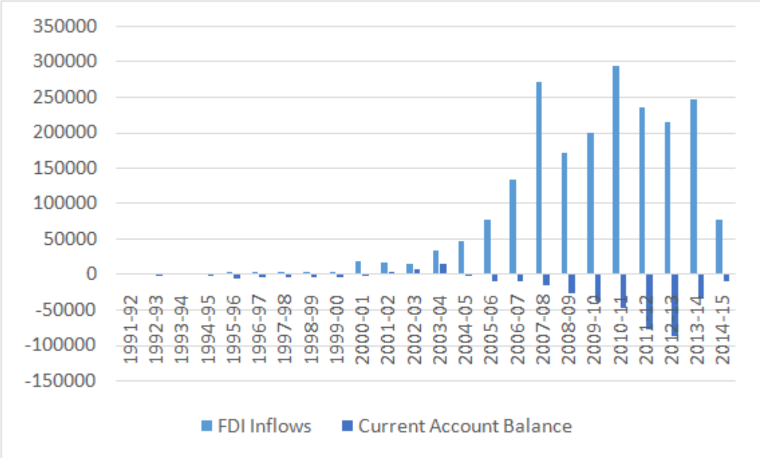

Figure 3

Source: *Prepared by the Author*

The chart above demonstrates the characteristic of Current Account Balance following a direct relation with the Foreign Direct Investment Inflows. With the increasing FDI Inflows overtime, the Current Account Balance also shows a widened deficit. As can be seen from the chart, increasing FDI Inflows since 1991 to 2007-08 have gone into increasing the CAD of India's Balance of Payment with an exception of a Surplus in Current Account Balance during the period 2001-02 to 2003-04. Moreover, yet again there showed a widening in the CAD after the period 2008-09 up till now. The factors responsible for this ongoing trauma of Current Account deficit due to increased FDI Inflows are repatriation of capital and profits to the foreign investor's country, increase in imports, export contraction, worsening conditions of domestic companies etc.

CONCLUSIONS

In this paper, we have analysed the trends in Foreign Direct Inflows and Current Account of India's Balance of Payments since 1991. The trend showed that Foreign Direct Investment Inflows and Current Account Deficit are directly related in the way that with a rise in FDI Inflows, the CAD also widens. This result is due to various consequences of FDI Inflows which affect the Current Account in a negative manner. There appears no second thought in the advantages Foreign Direct Investment is embedded with; transfer of technology, a betterment in skills and knowledge, increasing productivity, creation of employment opportunities etc. ; but it isn't free of dis-advantages in its very aftermath of leading the Current Account Balance to a deficit. So, this needs the attention of policy makers to accentuate FDI Inflows and battle the after effects associated with it in a manner that will not worsen Current Account Balance but, on the contrary, improve it.

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